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SIPDIS

SENSITIVE

DEPT FOR EAP/ TC

DEPT PLEASE PASS TO AIT/W

PLEASE PASS TO PETER SU IN THE BUREAU OF LEGISLATIVE
AFFAIRS (H)

E.O. 12958: N/A

TAGS: [OREP](#) [AMGT](#) [ASEC](#) [AFIN](#) [OTRA](#) [TW](#)

SUBJECT: SCENESETTER FOR CONGRESSMAN KENNEDY

REF: STATE 90490

Summary

11. (U) The United States has maintained unofficial relations with Taiwan under the Taiwan Relations Act (TRA) of 1979. The TRA commits the United States to offer defensive weapons to Taiwan, now the second largest purchaser of U.S. weapons systems in the world. Taiwan is governed by a multi-party democracy. In 2000, the independence leaning opposition party, the Democratic Peoples Party (DPP) won the presidency from the Nationalist Party (KMT), which had ruled since it moved to Taiwan from the Mainland in 1947. Since 2000, Taiwan has suffered from gridlock with the DPP controlling the presidency and the KMT controlling the legislature. One result of that gridlock has been an inability to approve a USD 18 billion appropriation for the purchase of defensive equipment approved by the United States in 2001. Taiwan's economy, long one of the most successful in Asia, hit its first recession in 2001; and growth has been slow with 2005 GDP growth expected to be below 4 percent. Outstanding trade issues between the U.S. and Taiwan include intellectual property rights, market access for pharmaceuticals, telecommunications, and rice. Despite cross-Strait tensions, the economy increasingly depends on exports to Taiwan's PRC-based manufacturing. (End summary.)

U.S.-Taiwan Relations - Security and Trade

12. (U) On January 1, 1979, the United States changed diplomatic recognition from Taipei to Beijing. In the U.S.-P.R.C. Joint Communique announcing the change, the United States recognized the Government of the People's Republic of China as the sole legal government of China and acknowledged the Chinese position that there is but one China. The Joint Communique also stated that within this context the people of the United States would maintain cultural, commercial, and other unofficial relations with the people of Taiwan. In April 1979, Congress passed the Taiwan Relations Act (TRA) creating the legal authority for the establishment of the American Institute in Taiwan (AIT), a private nonprofit corporation.

13. (U) Under the TRA, the United States is committed to offer defensive military weapons to Taiwan. A USD 18 billion Special Defense bill to purchase diesel submarines, P-3C anti-submarine patrol aircraft, and PAC-III anti-missile batteries has been under consideration by the LY for a full year. Political bickering and the resulting legislative gridlock have thus far kept the bill bottled up in the procedural committee.

14. (SBU) Market access and trade issues are the main concerns in U.S.-Taiwan economic relations. Taiwan joined the WTO in 2002 and committed to reduce barriers to trade in several areas, including telecommunications and government procurement. Many of these commitments remain incomplete. For several years, intellectual property rights have also been a key point of contention. Taiwan has been a center for piracy of optical media and has seen an influx of counterfeit products, including pharmaceuticals and branded goods, from China.

15. (SBU) However, in the last year, Taiwan has improved enforcement of its intellectual property laws, passed an amended Copyright Law, and proposed legislation to create a data-protection regime for pharmaceuticals. These improvements led the U.S. Trade Representatives office to recognize progress by shifting Taiwan from the Special 301 Priority Watch List to the Watch List in an out-of-cycle review in early 2005. The U.S. still has concerns about market access for pharmaceuticals and telecommunications service providers. In a major step forward on trade relations, on April 16, 2005 Taiwan lifted its ban on imports of U.S. beef. Taiwan health authorities led the way

for Asian economies by following a careful and credible review of procedures following the detection of BSE in the U.S. We also continue discussions with Taiwan on its tariff and quota regime for rice imports. On November 29, the U.S. and Taiwan resumed talks under the Trade and Investment Framework Agreement to further progress toward resolving outstanding issues.

Politics: Divided Government, Legislative Gridlock

16. (U) Chen Shui-bian's election as President of Taiwan in 2000 marked the first transfer of political power between parties in Taiwan since World War II and the consolidation of multi-party democracy in Taiwan in the 1990s. Over the past five years, Chen's independence-leaning Democratic Progressive Party (DPP) has asserted increasing control over the executive branch bureaucracy, which had been dominated for decades by the Kuomintang (KMT). In March 2004, Chen was narrowly reelected with less than 50.1 percent of the popular vote. A controversial shooting incident the day before the election, in which Chen and Vice President Annette Lu were mildly injured, and the KMT's refusal to accept the results of the 2004 election created a bitter partisan environment in the run up to the December 2004 Legislative Yuan (LY) election.

17. (SBU) The December 2004 LY election constituted a setback for President Chen and his DPP's hopes for winning a majority of LY seats. The DPP and its "Pan-Green" coalition partner, the pro-independence Taiwan Solidarity Union (TSU), had hoped to take control of the legislature for the first time. Instead, the "Pan-Blue" coalition, consisting of the former ruling Kuomintang (KMT) and the People First Party (PFP), won a razor-thin majority of LY seats, but promptly split, leaving no workable majority in the LY. As a result, the first LY session (February-May 2005) was characterized by gridlock, with few pieces of legislation enacted. Efforts to form ad-hoc legislative alliances to pass specific legislation have been episodic and only occasionally fruitful.

18. (SBU) The DPP's December election setback also showed the limits of Taiwan voter support for the radical pro-independence DPP campaign platform. Since then, President Chen has followed a more moderate course, trying to appeal to the majority of voters who support continuation of the status quo rather than immediate unification or independence.

Economy - Slowing Growth

19. (U) Taiwan is the 17th largest economy in the world. For nearly 50 years before 2001, Taiwan experienced rapid economic expansion, low unemployment, and low inflation -- often called "Taiwan's Economic Miracle." In 2001, the economy contracted for the first time since 1952, largely due to fallout from the global high technology industry downturn that reduced demand for exports in the key markets of the U.S., Europe and Japan. After two more years of disappointing growth in 2002 and 2003, double-digit export growth propelled the economy to nearly 6 percent real GDP growth in 2004. Export growth has fallen, and economists now predict that Taiwan's economy will slow significantly in 2005 with growth below 4 percent. This is low historically for Taiwan and disappointing compared to the performance of its neighbors and competitors.

110. (U) Exports of information technology and other high-tech goods continue to be one of the main drivers of Taiwan's economy, even as many firms move manufacturing operations to China or Southeast Asia. In 2004, Taiwan's exports grew more than 20 percent over the previous year. Semiconductors have been an especially important component of Taiwan's economic success. According to some estimates the integrated circuit industry by itself accounts for 3 percent of Taiwan's GDP, excluding the suppliers and customers who rely on the industry. Today, flat panel displays are also playing an increasing role. Taiwan's manufacturers of thin film resistor liquid crystal display (TFT-LCD), the most widely used type of flat panel display, control more than 40 percent of the TFT-LCD global market. Taiwan's government has plans to continue to stimulate the growth of these high-tech sectors, as well as to develop new technologies such as biotechnology and nanotechnology. Taiwan's government also hopes to diversify Taiwan's economy beyond manufacturing into digital content, logistics, finance and other services.

111. (U) Taiwan's macroeconomic policy has sought to maintain stable exchange rates, low inflation and low interest rates. Taiwan, after China and Japan, has the third largest stock of foreign exchange reserves in the world. It has made progress in strengthening a banking system that was in serious trouble in 2001 and 2002 and improving the supervision of financial institutions. However, the Taiwan government has yet to fully deal with a number of insolvent

institutions. Taiwan's eroding tax base, a "no new taxes" pledge (which it broke last week), and growing social welfare costs have left the Chen administration with a large budget deficit and limited options to pursue new spending on key economic and defense objectives. In the context of the continuing legislative gridlock, the budget crunch will continue unless Taiwan manages to choose between the politically difficult options of raising taxes, cutting popular social programs, or running historically high deficits.

Cross-Strait Tension and Economic Integration

12. (SBU) While strained political relations with Beijing dominate both Taiwan's domestic politics and national security issues, investment in the Mainland and trade across the Strait are increasingly the driving forces in Taiwan's economy. The recent visits to Mainland China by "Blue" opposition party leaders Lien Chan (KMT) and James Soong (PFP) have been hailed as an opportunity to improve cross-Strait relations and have raised expectations in Taiwan. The U.S. Government praised the visits and urged Beijing to start direct contacts with the elected representatives of Taiwan. However, PRC authorities and the Chen administration have not been able to find a mutually acceptable basis for direct contacts.

13. (U) In 2003, China replaced the U.S. as Taiwan's number one trading partner. Exports to the PRC and Hong Kong make up 35 percent of Taiwan's total exports. Many of these exports are inputs destined for Taiwan-owned manufacturing facilities in the Mainland. The PRC accounted for more than 67 percent of Taiwan's outward foreign investment in 2004. Much of Taiwan's labor-intensive manufacturing has moved to the Mainland, especially in industries like textiles, shoes, toys, furniture, etc. In information technology and other high-tech industries, the manufacture of the most advanced and capital-intensive components has in large measure stayed in Taiwan, while downstream assembly of final products has moved to Mainland China. However, increasingly Taiwan investors are moving the manufacture of upstream high-tech components to the PRC as well. Currently, about 70 percent of information technology products produced by Taiwan firms are assembled in the PRC. The Taiwan government continues to restrict investment in the Mainland for certain categories of high-tech manufacturing. However, Taiwan firms have been strongly urging the government to liberalize investment in more advanced semiconductor manufacturing technologies, semiconductor packaging and testing, and small-size TFT-LCD panels. Most of the electronics consumer goods manufactured by Taiwan firms in the PRC are still exported to the U.S., Japan, or Europe. However, Taiwan economic dependence on PRC domestic markets is growing across a range of industries.

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